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C O N F I D E N T I A L SECTION 01 OF 05 ASMARA 000683

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SUBJECT: ERITREAN FREE TRADE ZONES - GSE'S PLANS AND POST  
ANALYSIS

REF: ASMARA 615

Classified By: CDA Holly C. Holzer, for reasons 1.4 (b)  
and (d).

¶1. (C) Summary: On July 26, the Public Affairs Section featured Dr. Araia Tseggai, Chief Executive Officer of the Eritrea Free Zone Authority (the Authority), as speaker for the monthly American Center lecture. Part I of this cable reports on Dr. Araia's presentation of the Government of the State of Eritrea's (GSE) plans for establishing Free Zones (FZ) in Eritrea. Part II provides Post's analysis of the GSE's probable approaches in implementing these plans, within the context of the GSE's strict control over all aspects of the Eritrean economy and points out the loopholes the GSE has established to ensure that only the government and the sole political party reap the benefits of the FZ. GSE envisions the FZs as means to secure a dependable supply of hard currency entirely under their control and most importantly - without having to make any economic reforms - the GSE will be better able to maintain the political status quo. End Summary.

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PART I: DR. ARAIA PRESENTS THE GSE'S PLANS FOR FREE ZONES  
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ERITREAN CONCEPTS FOR A FREE ZONE

¶2. (U) Dr. Araia began his July 26 presentation with a background on GSE's thinking on establishing Free Zones. Following Eritrea's independence in 1993, the GSE sent economists to Dubai and Singapore to explore how free trade zones would work for their new country. (Note: Although the rest of the world refers to these areas as Free Trade Zones, the GSE prefers to refer to them Free Zones. End Note.) The GSE studied the matter for eight years before deciding in 2001 to make the port city of Massawa Eritrea's first FZ. Assab, Eritrea's other port city, is scheduled to become the second FZ in late 2007. Araia said that the GSE plans to eventually establish multiple FZs in Eritrea, and that a FZ could be designated for something as small as a single building or factory. Each entity within the FZ will be treated "as an Embassy", and local rules and regulations will be set aside in order to attract investors.

¶3. (U) Araia claimed that the primary purpose of an FZ is not

to make money, although a successful FZ will increase revenues to the GSE by developing the economy through attracting trade and investment. He added that the GSE will not view these entities as "cash cows", but rather as mechanisms to transform the Eritrean economy by creating jobs and bringing in international business expertise. Araia noted that 40,000 ships pass through the Red Sea annually but very few dock at Eritrean ports. Developing Massawa and Assab as FZs will attract more of these ships to Eritrea along with associated industries. Araia assesses that attracting even 1 percent of this shipping traffic will have a significant impact on the Eritrean economy. (Note: Post has heard from various sources that neither harbor is naturally configured to handle large amounts of shipping traffic nor large vessels. End Note.)

#### HARD CURRENCY BENEFITS

14. (U) According to Araia, all business transactions, internal and external, with the FZs will be conducted only in dollars. If a transaction takes place between an entity in the FZ and one inside Eritrea, the transaction will be calculated in dollars however the payments within Eritrea must be paid in the local currency (nakfa). All currency exchanges between dollars and nakfa must be conducted through the Eritrean Central Bank. Araia noted that these transactions will result in a 97 percent profit to the central bank, commenting this is an exchange of "paper for dollars, nothing for something" and that the GSE anticipates these transactions would become their primary source of hard currency revenue.

#### WORK STANDARDS

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15. (U) Araia stated that the GSE will maintain high labor and environmental standards within the FZs. Work days will be restricted to eight hours and overtime pay will be required for extra hours worked, although there will be no mandated minimum wage. (Note: The suspension of the minimum wage requirements provides a typical example of the GSE ignoring its own laws. End note.) Health and safety regulations will be enforced and there will be "published procedures for hiring and firing workers". International environmental conventions, especially in regard to the coastal waters, will also be strictly enforced.

16. (U) Other published rules for the FZs include:

1A. The GSE will establish FZs throughout the country in order to transform the economy.

1B. The FZs will be directly governed by a board of stakeholders, not the GSE.

1C. No officials of the GSE or the sole political party, the People's Front for Democracy and Justice (PFDJ), will be permitted to have direct business interests in the FZs. Both the GSE and PFDJ will only be able to conduct activities within the FZs at the request of the board, and to provide crucial services such as infrastructure construction.

1D. Eritrean companies must represent 50 percent of the businesses operating in the FZs. Only companies with a proven business track record will be allowed to operate in the FZs.

#### BENEFITS TO THE PEOPLE

17. (U) Araia stated that the FZs will significantly increase employment and develop higher skill sets for Eritrean workers. He added that modern production methods will be transferred from within the zone to domestic enterprises and that Eritrean companies will learn to successfully provide products that the rest of the world will want to buy. He noted a case where a PFDJ-owned company attempted to export locally produced gin and cognac to Japan, but the Eritrean produced bottles could not be opened by the Japanese nor did

they meet international standards. Araia cited this as an example in which a Free Zone could have assisted Eritrean businesses in learning to market to customer needs through interaction with international companies. Araia also stated that the FZs will increase both the quantity and diversity of goods within Eritrea.

#### BENEFITS TO INVESTORS

18. (U) Araia commented that the GSE "does not want the entire world to come," but felt that Eritrea possesses advantages that will attract a number of investors. (Note: The GSE has been selectively courting potential investors for the FZs, approaching only those countries deemed politically strategic and unlikely to be critical of its regional policies or treatment of Eritrea's citizens. End note.) Araia stressed Eritrea's valuable location on the Red Sea and referred to Assab as the port with the lowest overhead in the region, adding that it was "second only to Singapore in the calmness of its waters". He commented that Eritrea is the gateway to Africa due to the international affiliations in East Africa and through Central Africa into West Africa, and that Eritrea "has some valuable natural resources and tourism potential". Araia emphasized that Eritrea's best asset was low cost of operations, in particular, claiming that Eritrean labor was more "productive than in surrounding countries" and very cheap. The GSE aims to become the cheapest FZ in the region, he added, and Eritrea will compete on price with any other country, even going so far as "to offer free land" to attract development.

19. (U) Other stated benefits to investors included:

- 1A. No taxes on income, profits, or dividends;
- 1B. No customs duties on imports or products;
- 1C. No convertibility restrictions on currencies;
- 1D. No minimum level of investment;
- 1E. 100 percent foreign ownership allowed for investing companies;

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- 1F. 100 percent repatriation on profits and capital;
- 1G. Cheap land leases, renewable every 15 years; and
- 1H. A one-stop shop for all governmental interaction.

#### WHAT HAS THE GSE DONE SO FAR?

110. (U) No progress was made on implementing FZs in Eritrea from 2001 to 2003. The Authority took over the old Eritrean Naval base in Massawa in 2003 and now uses it as its headquarters. Araia stated that, as of today, two companies from Dubai are licensed to set up operations in Massawa and a total of twelve companies are registered and waiting for licenses. Twelve more companies - mostly from China but also from Italy, Germany, and Dubai - are considering investing in Massawa and Assab. Investors are interested mostly in salt, flowers, refining oil in Assab, and seaport/airport management. Araia added that "many companies" have demonstrated interest but are waiting until operations actually begin before inquiring more seriously. These companies include Cargil from the U.S., Horizon from Bahrain, the Qatar Investment Agency, and LaFarge from Geneva. Local news reports in July stated that Chinese government representatives signed several trade deals with the GSE and visited Massawa to examine potential investments.

#### EXPANDING THE PORT OF MASSAWA

111. (U) Recent news reports in Eritrea mentioned that three massive new cranes have been installed in the port of Massawa among other recent improvements totaling between \$30 and \$35 million. The Authority is also building shell facilities that can be quickly re-purposed to meet the needs of investors. These buildings are very large, open structures with easily changeable internal layouts. In Massawa, the Authority converted three old Navy mess halls, built seven

new warehouse-sized facilities and are constructing at least six more. Araia said that the first investors from UAE (business unspecified) will begin production within two or three months and will soon advertise for workers.

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PART II: POST ANALYSIS  
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CONCEPTS FOR FZS VERSUS CURRENT REALITIES

¶12. (C) Araia painted a very bright picture of the projected operations of Eritrean FZs but did not address the other underlying motivations of the GSE nor the loopholes established to ensure the GSE maintains complete control over the FZ and the Eritrean partners. The GSE's economic policies for the last six years seem little more than pillaging existing assets, luring unsuspecting investors into the country prior to changing business rules to the point that they can no longer operate, and shaking down individual business owners for hard currency. While these policies initially met the GSE's immediate currency needs, investors have grown wiser and the sources of these funds are not as readily available. In addition, most small businesses access to hard currency is extremely limited and most businesses are not permitted to exchange nakfa for hard currency within Eritrea, thus completely restricting their ability to operate. The GSE's primary economic goals continue to focus on ensuring dependable flows of hard currency and controlling all hard currency transactions made inside Eritrea. Thus, in the FZ, payments made by investors for salaries, utilities, and for other services in Eritrea proper will instantly become a nearly 100 percent profit to the GSE through currency conversion.

ENRICHING THE GOVERNMENT AND THE PARTY

¶13. (C) The GSE and the PFDJ will maintain complete control over the FS and will reap all of the benefits. Half of all companies in the FZ are to be Eritrean-owned, but only established companies are allowed to operate. In Eritrea, nearly all functioning companies are owned by either the GSE or by PFDJ's Hidri Trust. Araia's presentation revealed a means through which the GSE will be able to circumvent their own requirement that governmental and party entities are not

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to be represented in the zone by "allowing the creation of joint ventures with foreign companies" with the GSE for government-owned assets, such as seaports, airports, and the refinery in Assab and allowing for the FZ board to grant exceptions. (Comment: Post anticipates that like most of these purportedly independent non-government entities such as the FZ and the Eritrean Mining Corporation the board will be comprised of key party members and government officials. End Comment.) By requiring a proven track record and access to hard currency for operations, the GSE's policies essentially exclude any private Eritrean company (new or old) from operating in the zone other than as an outside supplier. Moreover, these contracts will likely accrue to government-owned entities as well. Because all transactions in the zone require payment in dollars, the GSE's restrictions on hard currency also will preclude any Eritrean small businesses from operating within the FZs.

WHO WILL GET THE JOBS?

¶14. (C) Another major question is who will get the jobs? Post envisions several different possible scenarios. One possibility, with known precedents, is that the GSE will establish a mechanism to assign individuals pressed into national service to provide labor in the zone. This would allow the GSE to receive dollar payments at the market rate for employees, but then make substantially reduced payments to the workers in nakfa. (Note: National service in Eritrea pays only the equivalent of \$30 per month, which is not

enough to support an individual, let alone a family. Those in national service must be financially subsidized by friends or family in order to survive. End note.) Using national service labor would provide a huge, additional bonanza to the GSE. Most companies engaged in business in the zone (predominantly from Persian Gulf countries and China) would likely acquiesce to using this labor pool, as long as the personnel payments remain below market prices and the GSE prevents any labor unrest in the zone. Araia emphasized that Eritrean FZs will always undercut their competitors and will not be outbid in terms of price; one way to accomplish this objective is through an assured cheap labor source.

¶15. (C) Araia said that an "advisory, not mandatory referral system for employment" will be created to assist matching employers and employees. Eritrea's high unemployment makes this system unnecessary, since employers receive multiple applicants for every job they advertise. This system could also be abused by the GSE for providing jobs to GSE and PFDJ supporters, such as ex-fighters. (Note: The GSE, as a matter of course, gives preferential hiring treatment to individuals who have served in combat, without regard for education or qualifications. For example, well-connected ex-fighters with little or no education often serve as judges in civil courts or in mid-level Ministerial positions. End note.) Post could easily envision the GSE imposing their hiring preferences through this referral process. Araia said that the GSE will control internal migration of labor to FZs to prevent overpopulation, which gives them effective control of the labor supply. Companies in the FZ who do not want to run afoul of Eritrean authorities will view it as less risky to hire employees in line with the referral system rather than hiring possible illegal workers. Controlling the hiring for these jobs would provide the GSE a good tool for rewarding their supporters such as ex-fighters and their families.

#### HOUSING

¶16. (C) The chronic shortage and high expense of remaining housing near the FZs presents another challenge to the GSE. Hundreds of individuals were displaced in Massawa when their neighborhoods were demolished to create space for the FZ. Araia claimed that all owners had been fairly compensated. Embassy officers have noted from several visits to Massawa over the last year that the displaced persons continue to struggle without evidence of governmental support and most been forced to move to existing, shoddy shanties made of discarded lumber, corrugated tin, and stones and compensation was non-existent. Araia indicated that the government will build rental housing for the FZ workers, with the rent deducted directly from employee paychecks.

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#### ASSAB ) A VIABLE FZ?

¶17. (C) Assab these days seems little more than a military camp. (See reftel.) Electricity is not available between 10:00 pm and 6:00 am, which effectively closes down the city during those hours. Before the 1998-2000 border war, Assab served as Eritrea's main port for trade with Ethiopia. Without the trade links to Ethiopia, Assab serves little purpose in purely economic terms, due to its remote location from the rest of the country. Araia noted that several companies from the U.A.E. were interested in operating the old, unused Russian-built refinery. He believes that some entity will eventually invest in the plant and begin operations if they are convinced that the worldwide shortage of refining capacity will continue and that refining margins will remain high. Other contacts have told Emboffs that the refinery is too antiquated to rehabilitate and would need rebuilding to be operational.

#### CONCLUSION

¶18. (C) The GSE is in desperate need of hard currency, and

the FZ is an option that could be a useful mechanism for them to meet their revenue goals, is dependable and entirely under their control. Due to Eritrea's small size, even a small amount of activity within the FZ could have a significant impact on the GSE-controlled economy. By offering much needed hard currency without requiring the GSE to make any reforms in the command economy, the GSE will gain greater economic security and thus maintain the political status quo.

HOLZER